

IMPORT SUBSTITUTION OR EXPORT PROMOTION?

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Introduction

During the early post-war period industrialization effort in Less Developed Countries (LDCs) was based on an import substitution (ISI) strategy. This was a result of the international trade pessimism of the 1950s and of the strong vested interests that strategy created. With the failure of ISI in achieving its goals, particularly after the late 1960s, there emerged an increasing interest among the LDCs in potentialities of an export oriented industrialisation (EOI) strategy. This paper will examine the validity of EOI strategies as an alternative industrialisation for achieving growth in the LDCs.

Export Orientation Versus Import Substitution

Export oriented economies generally tend to have lower barriers against imports and rely much less heavily on direct controls on imports and foreign exchange payments than import substitution economies. In the absence of substantial import barriers, domestic production is not protected from competitive imports. Production for exports generally receive higher rates of incentives than production for the domestic market. Thus production for export is more profitable than production for domestic use. Therefore, the policy package of EOI includes (a) exchange rate devaluation, (b) removal of discriminative measures against exports and (c) substantial reduction in quantitative restrictions and tariffs on imports. As advocates

of 'free trade' points out, transition to and EOI policy can end up in failure due to inadequate effective devaluation or inadequate removal of the bias against exports and resurgence of inflation (Streeten, 1982).

The policy of EOI is based on the arguments that international trade is the 'engine of growth' in LDCs. The argument for free trade is that the gains of comparative advantage are more than gains due to protection. (Assuming that factor endowments, technology and tasks are constant). (Findlay, 1984).

In principle, EOI focusses on achieving foreign exchange through exports while ISI focusses on saving foreign exchange by limiting imports. But under the ISI policy, LDC's imports are diverted from consumers goods to intermediate and capital goods. The new form of import dependency is considered even more unfavourable because the importing of intermediate and capital goods is regarded as essential for domestic production and to provide employment to the people. Thus in the absence of export expansion, LDCs are not capable of maintaining their growth in the long run.

Adam Smith's famous dictum that "the division of labour is limited by the extent of the market" points to the importance of an EOI strategy as a stimulus to the expansion of domestic production, based on economies of scale (Findlay, 1984). Furthermore, ...

while inward oriented countries travel up the staircase of comparative disadvantage, entailing increasingly higher costs, due to the limitations of the domestic market, outward oriented countries can specialize in products in which they have a comparative advantage" (Balassa, 1983:216). In addition, large scale production methods can be utilised and higher levels of capacity utilisation obtained as domestic market limitations are removed via international trade. This expansion of domestic production will also help to create more employment opportunities on these countries (specially if the new industries are labour intensive).

The neo-classical criticisms of ISI stress its ability to engineer as efficient allocation of resources. Because of factor market imperfections caused by overvalued domestic currency and the import restrictions against consumer items, ISI strategy leads to the emergence of an inefficient capital-intensive industrial sector in LDCs. This violates the principle of comparative advantage. In the absence of market distortionary measures, the EOI strategy facilitates the price mechanism to bring about an efficient allocation of resources in consonance with the country's comparative advantages.

These theoretical arguments postulate that an export oriented development strategy would result in a rapid increase of production and employment through a process of efficient industrialisation

1. The failure of ISI is a controversial issue. ISI strategy has led to the establishment of a domestic industrial sector in some of the LDCs. It was a prelude or a pre-requisite for export promotion in Japan and many of the other Newly Industrialised Countries (NICs). Some of the NICs such as South Korea and Taiwan have fruitfully used ISI strategies too as complementary economic policies to their EOI strategies. Some of the studies on this issue are available in Streeten (1982), Weiss (1986) and (1988).

2. In principle, ISI and EOI strategies are not mutually exclusive. In practice too, it is hard to distinguish between the countries which pursue ISI and EOI policies. However, in most of the literature these two types of strategies are considered as mutually exclusive.

process. The resurgence of 'trade optimism' based on the decisive shift of development thinking in the 1960s, has been rationalised by these arguments, in favour of an EOI strategy.

Validity of 'Export Optimism'

Limitations of Arguments

Inefficient use of resources or their misallocation due to excessive protection was one of the main criticisms raised against ISI strategies. It is argued that export oriented industries cannot be as inefficient as import substitution industries because "... world prices limit the extent to which social and private gains diverge from each other and value added cannot be negative in exports: but this is a fallacy" (Streeten, 1982:163). But the cause for inefficiency can be diverse. As Streeten (1982) points out, under a strategy of EOI excessive subsidies to inputs for export oriented industries can result in misallocation of resources.

Conventional arguments for free trade normally emphasise the merits of (a) the comparative advantage, (b) economies of scale and (c) efficiency through competition. As Streeten (1982) argues, whatever the independent merits of each of these phenomena, they are mutually inconsistent:

Let's consider the relationship between comparative advantage and competition. There is no reason to assume that all the firms within an industry which has (or has not) a comparative advantage, are efficient (or inefficient). When import barriers are removed, there is a tendency for these industries with comparative advantages to grow and others which do not have such comparative advantage, to contract. In the growing sector, inefficient firms will grow with efficient ones and in the contracting

sector, efficient firms will contract with inefficient ones. Furthermore, this expansion of those industries with comparative advantages in one country can result in the contraction of the same industries in other countries which do not employ such comparative advantage and thereof lead to a reduction on overall international competition.

The arguments for increased competition and greater economies of scale are also mutually inconsistent. If competition is measured by the increasing number of firms in an industry and if the gains of economies of scale in greater concentration, than these two are mutually exclusive.

There are many arguments which emphasise unfavourable (rather than favourable) effects of trade liberalisation and exchange rate devaluation in LDCs. The prominent 'infant industry' argument stands strongly in favour of the need for protection. "New industries would inevitably be high cost in international terms, and would thus need some protection from import competition" (Weiss, 1988:86). Removal of tariffs and other forms of barriers against imports accompanied by an EOI strategy may have adverse effects on domestic infant industries instead of increasing their efficiency. Many LDCs have suffered from these adverse effects.³

One of the main arguments against protection is that the ISI strategy has created an unfavourable 'import dependence'. But with the removal of import barriers, if domestic industries are adversely affected by competitive imports, there will be a resurgence of import dependency on consumer goods. This will be further stimulated by the shift of resources from import substitution industries to export oriented industries. On the other

hand, expansion of production in many well known, much of the manufactured exports from "...new exporters & consist of items which mainly involve the assembly of imported components..." (Athukorala & Bandara, 1987:110). Thus it can be argued that EOI may lead to an emergence of both 'essential' and 'non-essential' import dependency in LDCs. Export oriented economies are therefore more dependent on external trade and consequently, suffer greater losses, when external shocks occur (Streeten, 1982).

The conventional belief in the merits of exchange rate devaluation is based on its price effects on exports and imports. Increase of exports and decrease of imports through the price effects of devaluation inevitably require more flexible elasticities of demand for a supply of exports and imports. But in addition to that, favourable results of devaluation are subject to many other constraints. The most important point is that many of these constraints are external which cannot be influenced by the domestic economic policies.

On the export side, other competitive exports as well as importers should not devalue their currencies and importers should not pursue import restrictive policies. But this is unlikely since many new exporters from the Third World, will attempt to practice test to follow similar policies and therefore will be competing with each other in an international market which is characterised by increasing 'new protectionism' on the part of the Developed Countries.⁴

On the import side, for a reduction of imports through devaluation, suppliers of imports should not either devalue their currencies or follow any other forms of price reduction policies. A reduction of imports inevitably requires an

3. An ideal example of this is provided by the experience of Sri Lanka: Removal of protection accompanied by an EOI strategy in 1977 resulted in a contraction of output and employment in many domestic industries due to their failure to compete with imports. (Kelegama & Wignaraja, 1988:21). The number of affected or closed down manufacturing units were larger than the number of manufacturing units benefitted by the trade liberalisation after 1977 (Osmani, 1987:209).

4. After the late 1970s, a group of 'new exporters' of manufactured goods has emerged among the LDCs - the Newly Exporting Countries (NECs) of 'second-tier' exporters of manufactured goods. Studies of the expansion of production of the NECs are available in Findlay (1984), Havrylyshyn & Alikhani (1983) and OECD (1982).

increasing in the production of import substitution goods. As discussed earlier, the impact of 'free trade' on import substitution industries has not been favourable in many LDCs. Therefore, a devaluation may not reduce imports but will result in an increase in domestic inflation.

The Case of Japan and the NICs

Advocates of EOI policies often cite the success of Japan and other Newly Industrialised Countries (NICs) based on their export-led development strategies to buttress their arguments. But these are diverse interpretations of the rise of these countries, but many of those countries followed not just a policy of EOI but import substitution with related protection policies and stringent government intervention. For example, Streeten (1982:167) points out that the South Korea, a whole range of products that were imported in 1960 were produced domestically in 1977 and Korea adopted import restrictions to achieve this objective. In summarising Japan's industrial development, Weiss (1986:399-400) concludes that "... there is a period of production aimed primarily at the domestic market, normally under tariff or quota protection which allows the achievement of production experience, learning effects and economies of scale; finally, after a time, come break-throughs into export markets..." Thus, there is a much closer link between initial import substitution and later export success, which is not often illustrated by the statistical analysis of the export performance. As Kruger (quoted in Athukorala, 1986:102) suggests, "the mere absence of an import substitution bias does not seem to provide the required export push". In fact, the industrial success of Japan and other NICs

is not so much the result of 'natural' market forces as of determined government interventionist policies aimed at 'creating comparative advantage of the future' (Weiss, 1986)

External Constraints to Export Expansion

One of the main criticisms against ISI was that industrialisation process was limited by the narrow domestic market conditions. But there are crucial external factors which limit the expansion of export oriented production in LDCs. As Sir Arthur Lewis (1980) states, the prosperity of 1950-73 was special and not repeatable. Therefore, LDCs can increase their exports only if Developed Countries (DCs) are willing to give these LDCs a greater share of their markets. When DCs grow faster, the rate of growth of their imports accelerates and hence LDCs can export more.

This is consistent with a certain argument with regard to the success of the NICs that "the emergence of the NICs is seen as a response to a set of international circumstances which at one and the same time product relatively favourably access to markets of advanced countries..." (Schmitz, in Kapilnsky, 1984:9). Therefore, the expansion of exports of the LDCs depends on unstable external factors such as faster growth of DCs and their willingness to open their markets.

The 'new protectionism' of the DCs against exports from the LDCs has been increasing. "... DCs have been dismantling their barriers to each other's trade while increasing their barriers to LDC trade" (Lewis, 1980). Moreover, competition in international markets will also get through because of the increasing number of new exporters from among the LDCs.

Supply side of manufactured

expansion in LDCs is too largely determined by the external factors; manufactured production, often assembly-type specially emerged under the Direct Foreign Investments in LDCs heavily depends on the supply of imported inputs. Moreover, imported capital goods, technology and direct and indirect capital flows play a major role in industrialisation process in LDCs, mostly under the EOI, since EOI policy may facilitate their penetration into LDCs more than ISI.

Both demand and supply factors of expansion of export in LDCs are therefore mostly determined by unstable and unpredictable external market conditions. LDCs can grow and expand exports, only if these conditions are favourable.

CONCLUSION

Resurgence of 'export optimism' among the third world countries in the recent past was caused by the decisive change of development thinking in favour of an EOI strategy and the stimulus provided by the success of the pioneers of EOI, i.e. the so-called NICs. Regard mere export promotion under 'free trade' as the 'master key' to the growth and industrialisation in LDCs may be oversimplified and misleading. There are inconsistencies among some of the arguments in favour of free trade. Production can be carried out and resources can be allocated efficiently or inefficiently under the ISI as well as EOI strategies. There are external and internal factors which can act as constraints to the growth under both strategies. However, import substitution has been a pre-requisite and a complement for export promotion in industrialised countries. The question is now to use both types of strategies in an effi-

5. Exports from new exporters (NECs) are concentrated only on a few labour-intensive light manufactured goods. Product categories such as clothing, travel equipment, footwear, small electrical appliances and miscellaneous manufactures (with a large proportion of the first two items) make up 55% of their total exports of manufactured goods in 1977. (OECD, 1982)

6. If all LDCs reach the level of the four South East Asian NICs (i.e. South Korea, Taiwan, Singapore and Hong Kong), manufactured exports to DCs would rise seven fold and the share of these goods in imports of DCs would reach 60 percent (Weiss, 1986:58).

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cient way in individual developing countries.

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